



# AI & software disruption: impact on credit markets

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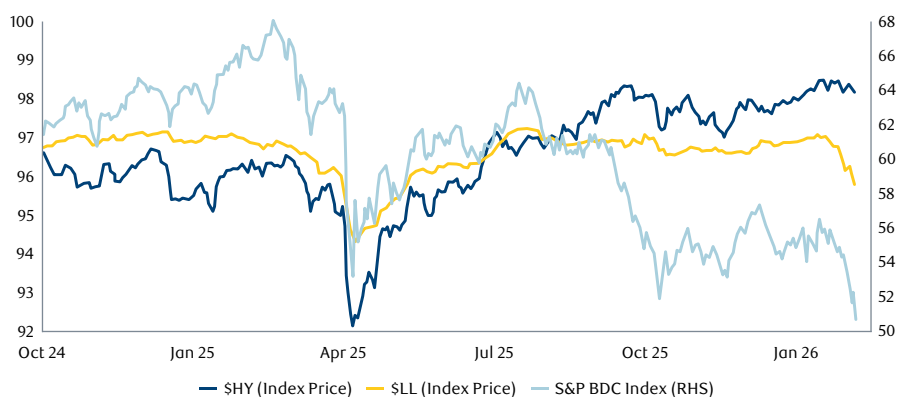
## Key takeaways:

- **Software in the crosshairs:** the technology sector – specifically software – sat at the centre of a repricing across fixed income in Q1, as concerns around structural obsolescence took hold. The greatest impact was felt in leveraged credit markets where software comprises a disproportionate share of portfolios.
- **Repricing creates opportunity:** this period of dislocation may create a relative value opportunity within US HY bonds against other leveraged finance markets. Lower exposure to software risk, improved structural quality, and strong technical demand positions US HY as a resilient and attractive segment of credit in an AI-driven market environment.
- **A more liquid alternative:** for investors seeking yield without concentration risk, the asset class offers a compelling solution – attractive all-in returns, genuine liquidity, and a backstop against software sector dislocations.

The first quarter of 2026 marked a clear inflection point for credit markets. A combination of geopolitical uncertainty, evolving AI-driven disruption risks, and growing scrutiny of private credit has driven a meaningful repricing across fixed income.

The technology sector – specifically software – sits at the centre of this repricing as concerns around structural obsolescence have taken hold. The greatest impact is being felt in parts of the leveraged credit markets where software and software services comprise a disproportionate share of portfolios.

**Exhibit 1: Price performance across leveraged finance sectors**



Source: Deutsche Bank, Bloomberg Finance LP, as of 9 February 2026.

While recent spread widening has been largely contained in the lower-rated and direct lending parts of the market, risk of broader market contagion is keeping investors vigilant.

In our view, this period of dislocation may, in fact, create a relative value opportunity within US high yield (HY) bonds, particularly when viewed against other leveraged finance markets. Lower exposure to software risk, improved structural quality, and strong technical demand positions US HY as a potentially more resilient and attractive segment of credit in an AI-driven market environment and strained economic backdrop.

### A meaningful repricing begins

Recent spread widening reflects a fundamental repricing driven by two interconnected themes that have left investors trying to pick up and put together the pieces.

#### 1. AI displacement risk

AI capabilities are evolving rapidly, shifting software from AI beneficiary to disruption target. Single-vertical and narrowly focused providers face structural obsolescence pressure, with investor concerns centered on:

- **Elevated default probability** as competitive moats erode.
- **Compressed recovery values** given asset light business models within software.
- **Accelerated reinvestment requirements** to remain competitive in an AI-native environment.

#### 2: Private Credit underwriting concerns amplified by sector concentration

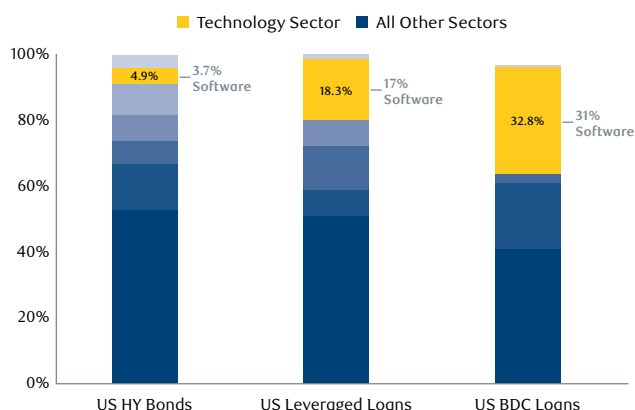
Years of capital flooding into private markets have caused more acute sector clustering within these portfolios. Software exposure varies dramatically by segment, with private credit ranging between 25-35% of exposure.

During this time, this growing concentration was masked by a zero-rate environment, when growth-at-any-cost narratives dominated. As rates normalised and AI displacement emerged, structural vulnerability became apparent.

### The missed concentration risks

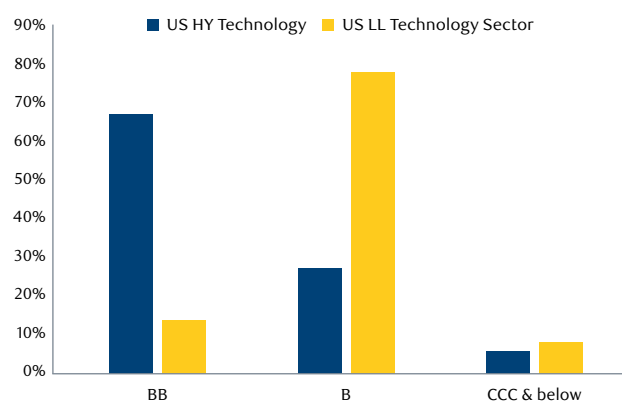
And perhaps what caught most investors off guard was where the largest concentration of this particular risk was held, and that certain segments of the market were more significantly exposed. The percentage of software exposure is much more heavily concentrated (Exhibit 2) and lower quality (Exhibit 3 and 4) in the US leveraged loan and BDC private credit markets than in US HY bonds. At the same time, on a asset growth basis, the incremental dollar has largely gone into these lower quality floating rate markets. As a result, concerns around lack of liquidity, lack of diversification and lack of transparent pricing seem warranted.

### Exhibit 2: Technology exposure across leveraged finance sectors



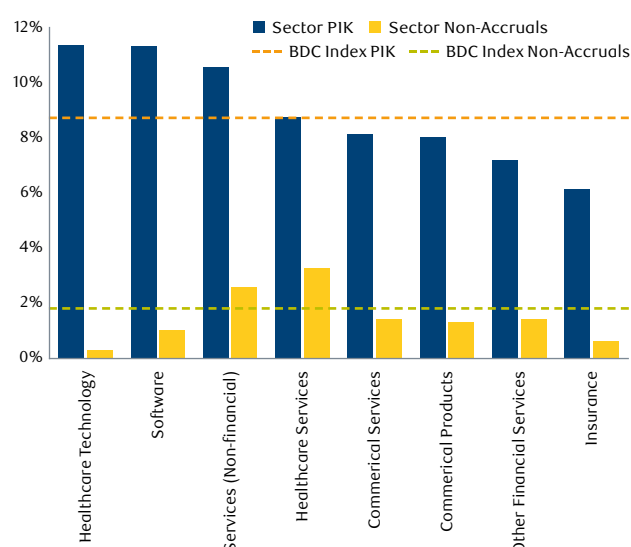
Source: ICE BofA, Bloomberg, as of 28 February 2026. Note: US High Yield Index refers to the ICE BofA US High Yield Index and Leveraged Loans refers to the Bloomberg US Leveraged Loan Index. BDC loans refer to subset of loans with instrument source = BDC in Bloomberg, USD only.

### Exhibit 3: US HY and leveraged loan tech sector quality breakdown



Source: Bloomberg, ICE BofA US High Yield Index as of 28 February 2026.

### Exhibit 4: BDC PIK & Non-Accrual rates by sector



Source: Deutsche Bank, Bloomberg Finance L.P., Pitchbook, S&P, as of February 9, 2026.

## Software selloff: what has been overdone and what risks still lie ahead?

We believe the concerns surrounding software are valid, but replacing core enterprise systems remains costly and risky. While immediate displacement threatens some companies, the bigger risk, in our view, is longer-term reinvestment pressure.

Below we identify the broad types of software at risk of potential AI displacement:

### Exhibit 5: Technology risk hierarchy

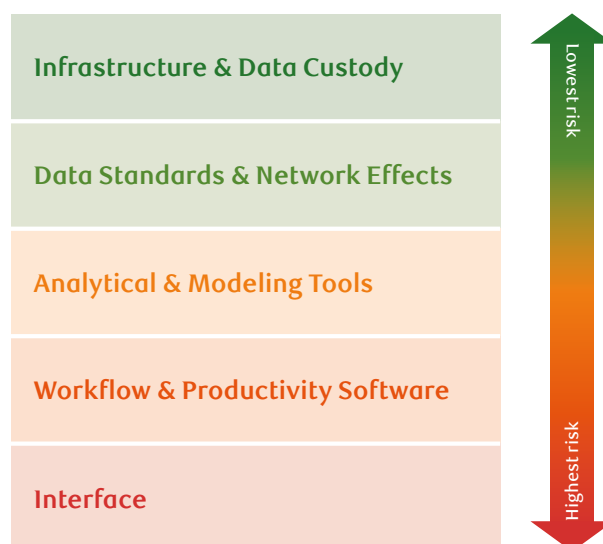
**Infrastructure & Data Custody:** System of record/central data repository for a company. Data ownership resides here - this is the layer AI trains on. There are storage standards here creating significant costs to switching, both structural and regulatory.

**Data Standards & Network Effects:** Proprietary data that becomes an industry standard - no substitution. The standard is the product.

**Analytical & Modeling Tools:** Industry-specific risk models and analytics used for data analysis and optimisation. This used to require expert teams, but AI is lowering the barriers to entry. The moat is still there but it's getting shallower.

**Workflow & Productivity Software:** This is the SaaS per seat layer - customer relationship management.

**Interface:** Immediate threat from AI - easy to replace. This is user interface to productivity tools and basic automation software.



Source: RBC Global Asset Management, February 28, 2026.

While we do not believe the entire software market will collapse overnight, companies are likely to face mounting pressure from margin compression, reduced capital access, and potentially declining revenues. The critical differentiator will be financial flexibility – companies with larger balance sheets, diversified revenue streams, and low leverage can absorb this pressure and invest in adaptation. Conversely, those with narrow customer bases, high leverage, and limited reinvestment capacity are likely to face accelerated default risk and lower, more binary, recovery values.

The degree and impact of to which this is felt will be largely driven by timing – how quickly displacement becomes entrenched versus how much runway markets provide for companies to adapt.

Beyond balance sheet metrics, management's track record in navigating technological disruption will prove critical. Companies whose leadership has demonstrated adaptability, vision, and capital discipline are better positioned to compete in an AI-reshaped market.

### Timeline Expectations

We expect the most acute default pressure within 12-18 months as:

#### Q1–Q2 2026

Customer churn and migration accelerates.

#### Q3–Q4 2026

Margin compression starts to flow through in guidance.

#### 2027+

Refinancing pressure mounts as debt matures into a structurally higher-rate environment.

Companies without clear competitive positioning by early 2027 will likely face meaningful default risk.

## Broader contagion concerns are mounting

Historical precedent suggests sector concentration can trigger acute default cycles. Telecom exposure in high yield during the early 2000s offers a cautionary parallel. Today's market faces similar dynamics, potentially amplified by several interconnected factors:

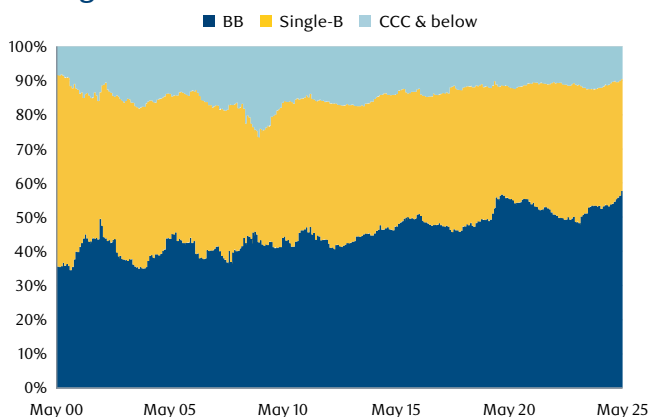
- **Bank line dependence:** Private credit's reliance on bank facilities creates liquidity vulnerabilities as lenders retreat.
- **Sponsor-borrower overlap:** Concentrated exposure across private credit and private equity ecosystems.
- **Sector concentration:** Leveraged loan and private credit markets heavily skewed toward software companies.
- **Interest rate environment:** Structurally higher rates, with potential upward pressure from geopolitical events and supply chain disruptions, are unlikely to provide relief for elevated debt capital costs for these companies.

While not our base case, we acknowledge the tail risk: should inflation re-accelerate alongside near-term refinancing pressures, these concentrated positions could face acute stress. The combination of structurally higher rates and reduced capital access would leave weaker issuers with limited options.

## Our take on how to navigate this market

Despite this, we do think there are many reasons to stay invested today. In our view, investors can either take a diversified approach to the leveraged finance market – allocating capital across sectors and within-sector opportunities in an increasingly fragmented market environment - or focus on traditional US HY bonds, emphasising carry and spread compression in quality companies with large, liquid capital structures.

**Exhibit 6: Rating allocation across the US High Yield Index**



Source: ICE BofA, January 31, 2026.

Note: US High Yield Index refers to the ICE BofA US High Yield Index and European High Yield Index refers to the ICE BofA Euro High Yield Index.

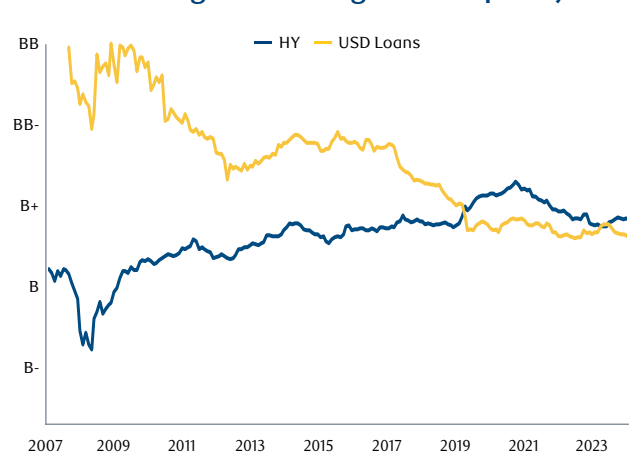
## US HY as the alternative to Alternatives

With concerns around concentration risks and deteriorating underwriting standards in leveraged loans and private credit, these allocations are already starting to be reassessed by investors.

As a result, we could see a longer term rotation away from these markets and into traditional high yield bonds. The reason for this, we believe, is because in addition to offering compelling all-in yields, the US HY market benefits from a number of structural advantages:

1. **Lower software sector exposure:** Software represents only 3.5% of the US High Yield Bond index, compared to 25-35% in private credit and ~17% in leveraged loans.
2. **Improved credit quality backdrop:** Many US HY issuers are larger, more liquid and higher quality companies. The market has experienced continued improvement in overall credit quality over the past two decades, with meaningful migration from CCC to BB/B ratings (Exhibits 6 and 7).
3. **Sector diversification mitigates concentration risk:** While not void of higher concentrations in some sectors, like Energy and Telecom, US high yield is meaningfully more diversified than other leveraged credit markets.
4. **Liquidity as an alpha generation and risk management tool:** Increased dispersion and market fragmentation reward actively managed liquid portfolios by enabling tactical rotation and value capture. At the same time, it allows for managers to quickly adjust their risk exposures within portfolios, something not afforded to the less liquid, or in many cases, illiquid, parts of the market.

**Exhibit 7: Weighted average credit quality**



Source: BofA, as of February 2026.

## **US HY's unique position of strength amid AI disruption risk**

Unlike leveraged loans and private credit, software represents only 3.5% of the US High Yield index (as represented by the ICE BofA US High Yield Index) – providing natural diversification that private alternatives cannot replicate. Critically, US HY's daily liquidity enables tactical repositioning, whereas private credit investors face redemption gates and lock-up constraints that force them to absorb concentration risk indefinitely.

For investors seeking yield without concentration, US HY offers a compelling solution: attractive all-in return potential, genuine liquidity, and a quality backstop against further software sector dislocations. In an environment of rising defaults, margin compression, and refinancing uncertainty, the choice between concentrated, illiquid exposures and diversified, liquid US HY is becoming increasingly clear.

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